

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of        )  
SELEGNA PETROLEUM CORPORATION        )

Appearances:

For Appellant: Philip Wain, Certified Public Accountant  
and President of Appellant

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Selegna Petroleum Corporation to proposed assessments of additional franchise tax in the amounts of \$73.84, \$280.54 and \$863.24 for the income years ended March 31, 1952, 1953 and 1954, respectively, and, pursuant to Section 26077 of the Revenue and Taxation Code, from the action of the Franchise Tax Board in denying a claim for refund of franchise tax in the amount of \$1,451.93 for the income year ended March 31, 1956.

Appellant was incorporated in 1937. It owns and operates producing oil wells in California and Illinois and is engaged in the production and sale of crude petroleum. Prior to 1951 all of Appellant's stock was owned by Mrs. Carla Stafford-Lewis. Mrs. Lewis had borrowed \$70,000 and pledged the stock of Appellant as collateral. Repayment was long overdue and foreclosure was threatened. She was unable to arrange another loan and on February 17, 1951, sold her stock to Philip Wain, J. D. Shane and I. Rosenus for \$125,000. The sale agreement contained an option giving her the right to repurchase the stock for \$175,000 within a specified time. She had assumed that Appellant's assets were worth considerably more than the price at which she sold the stock and she had obtained the option for the purpose of attempting to locate a buyer to whom the option could be assigned. She was unsuccessful in obtaining a buyer and the option period expired.

In 1953, Mrs. Lewis brought suit against Wain, Shane and Rosenus alleging that the purported sale of stock was in reality a loan and sought the return of the stock. Judgment was entered against Mrs. Lewis in the superior court and this judgment was affirmed on appeal.

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Mrs. Lewis had withdrawn substantial sums from Appellant, a portion of which had been repaid. Prior to the date of sale of her stock, February 17, 1951, she still owed to Appellant the amount of \$51,866.91. For the income year ended March 31, 1952, Appellant took a deduction of \$5,186.69 (10% of the amount owed by Mrs. Lewis) as a partially worthless debt. For the income year ended March 31, 1953, a like amount was deducted as a partially worthless debt. For the income year ended March 31, 1954, the remaining amount (\$41,020.10) was deducted.

Following the issuance of the assessments for the income years ended March 31, 1952, 1953 and 1954, Appellant filed a claim for refund for the income year ended March 31, 1956, claiming that the \$51,866.91 indebtedness of Mrs. Lewis became worthless in that year. Appellant does not claim a double deduction but contends that if this indebtedness did not become worthless during the three earlier years on appeal, it did become worthless during the last year on appeal.

Prior to 1951 Appellant, through Mrs. Lewis as its president, had executed two promissory notes to a bank in the sums of \$5,000 and \$200. These amounts were not recorded in Appellant's account and did not appear on its balance sheet. At the time of the sale of the stock Mrs. Lewis had warranted that Appellant had no outstanding contracts or commitments not shown on its balance sheet.

Subsequent to the sale of the stock the notes were called to the attention of Wain Shane and Rosenus by the bank. Appellant paid approximately \$5,800 in principal, interest and costs before the notes were cancelled. In the above-mentioned suit filed by Mrs. Lewis, Wain, Shane and Rosenus cross-complained and were awarded a money judgment on account of the breach of Mrs. Lewis's warranty. The judgment was never paid and on its return for the income year ended March 31, 1953, Appellant deducted \$5,355 as a bad debt and for the income year ended March 31, 1954, deducted \$1,000 as a bad debt.

On its return for the income year ended March 31, 1954, Appellant deducted \$14,969.84 as the cost of defending the suit brought by Mrs. Lewis. The total expenses of defending the suit were in excess of this amount by \$3,750 but Wain, Shane and Rosenus individually paid such excess.

Respondent disallowed all of the above-mentioned deductions. Respondent contends that the \$51,866.91 indebtedness of Mrs. Lewis was cancelled on February 17, 1951, which was before the beginning of the earliest of the income years in question. Respondent also contends that the unpaid judgment for breach of warranty arising out of the two promissory notes not disclosed in Appellant's

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balance sheet was an indebtedness owed by Mrs. Lewis to Wain, Shane and Rosenus and is therefore not deductible by Appellant. Respondent disallowed the deduction for costs of defending the suit on the ground that the expenditure was for the benefit of Wain, Shane and Rosenus and not for the benefit of Appellant.

In the suit brought by Mrs. Lewis against Wain, Shane and Rosenus the plaintiff contended that the price paid for her stock was well below the fair value of the stock and that from this the court should find that a loan rather than a sale was intended. The trial court rejected this contention. In affirming the judgment, the appellate court in Stafford-Lewis v. Wain, 128 Cal. App. 2d 614, pointed out that the trial judge had asked Shane about the debt of Mrs. Lewis appearing on the books of the corporation and that Shane had replied "Nothing was said. Inferentially it was indicated that we didn't consider that a real obligation and one that would ever be considered to be paid by Mrs. Lewis." The appellate court also pointed out that although defendants cross-complained regarding the two undisclosed promissory notes they did not seek to recover any balance due Selegna from plaintiff and that no attempt was made to collect the latter amount. The court concluded that "when this deal was made none of the parties regarded this account as one plaintiff was expected to pay."

Appellant argues that Mrs. Lewis not only admitted, but contended that she was indebted to Appellant, that the debt was not removed from Appellant's books and that Wain, Shane and Rosenus could not have cancelled the debt due to it in negotiations carried on before they were stockholders. Mrs. Lewis contended that she was indebted to Appellant as part of an effort to retain title to Appellant's stock. None of the defendants in the lawsuit admitted or contended that the debt was due. On the contrary, Shane testified that it was not expected to be paid. Even though Wain, Shane and Rosenus were not yet stockholders when the negotiations for sale of the stock were being conducted, Appellant was bound by the understanding arrived at since all parties having any voice in its affairs, then or in the immediate future, were represented. It should be noted that the court was aware of all of the points here advanced by Appellant, yet it found that the debt was cancelled.

Appellant also states that the Internal Revenue Service has allowed its deductions on account of the debt in question for the years ended in 1952 and 1953. We do not know the specific reasons for the allowance by the Internal Revenue Service. We do know the facts upon which the court relied. Upon the same facts that persuaded the court, we also find that the alleged debt of \$51,866.91 was not expected to be paid. It follows that Appellant is not entitled to deduct any part of it as a bad debt.

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With respect to the two notes executed in favor of the bank, the fact that they were not disclosed on Appellant's balance sheet amounted to a breach by Mrs. Lewis of her contract with Wain, Shane and Rosenus. Their inability to collect damages for this breach from Mrs. Lewis affords no basis for a bad debt deduction by Appellant. The wrong was not to Appellant but to the stockholders of Appellant individually. The notes were executed by Appellant through Mrs. Lewis as its president and there is no evidence that the amount of the notes constituted a debt owed to Appellant by Mrs. Lewis.

On the question of the legal expenses, the lawsuit between Mrs. Lewis and Wain, Shane and Rosenus was primarily for the purpose of determining title to the stock. Any effect on Appellant or its operations was indirect and inconsequential. The defense did not involve any attempt to establish that any amount was due to Appellant. The legal expenses were personal expenses of the stockholders and Respondent was thus correct in disallowing such expenditures as a deduction by Appellant.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Selegna Petroleum Corporation to proposed assessments of additional franchise tax in the amounts of \$73.84, \$280.54 and \$863.24 for the income years ended March 31, 1952, 1953 and 1954, respectively, and, pursuant to Section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Selegna Petroleum Corporation for refund of franchise tax in the amount of \$1,451.93 for the income year ended March 31, 1956, be and the same are hereby sustained.

Done at Sacramento, California, this 8th day of June, 1961,  
by the State Board of Equalization.

<u>John W. Lynch</u>	, Chairman
<u>Geo. R. Reilly</u>	, Member
<u>Richard Nevins</u>	, Member
<u>                    </u>	, Member
<u>                    </u>	, Member

ATTEST: Dixwell L. Pierce, Secretary